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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 001237

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DEPT FOR EUR/CARC AND EEB A/S SULLIVAN; TREASURY FOR DAS
NANCY LEE

E.O. 12958: DECL: 10/11/2017

TAGS: [ECON](#) [EFIN](#) [ETRD](#) [ENRG](#) [PREL](#) [PGOV](#) [AJ](#)

SUBJECT: SCENESETTER FOR AZERBAIJANI FINANCE MINISTER
SHARIFOV'S TRIP TO WASHINGTON, OCTOBER 20-24

REF: A. BAKU 1124

[B](#). BAKU 1085

[C](#). BAKU 1227

Classified By: Ambassador Anne E. Derse per 1.4 (b,d).

[1](#). (C) Summary: As the GOAJ's leading economic advisor, a new "reformist" Minister and member of President Aliyev's inner circle, Finance Minister Samir Sharifov is key to the GOAJ's efforts to successfully manage its GDP growth of 35 percent and projected USD 200-250 billion in energy revenues and reform Azerbaijan's budget and public investment process.

The IMF believes that Sharifov, along with State Oil Fund (SOFAZ) Executive Director Shamar Movsumov (who will accompany Sharifov to Washington for IMF/World Bank meetings October 20-24), is doing a competent job of steering Azerbaijan's macroeconomic policy. Sustained, high-level policy engagement with Sharifov is essential to help Azerbaijan manage its precarious economic position and promote U.S. interests in this strategic country; it also is key to managing our financial relationship with Azerbaijan's emerging sovereign wealth fund, which already invests heavily in U.S. Treasury bonds. Azerbaijan is investing a significant amount of its energy revenues in capital expenditures, and wants to partner with U.S. firms on major new projects -- GE Turbines, petrochemical projects, a new refinery, and new roads -- that Sharifov plans to discuss in Washington. In addition to being the lead on finance and macroeconomic management in the GOAJ, Sharifov is also a player on industrial development, reform, and energy issues and has expressed an interest in U.S. technical assistance in developing a gas transit regime through Turkey; he also plays a key role in Azerbaijan's WTO accession process, which is moving forward steadily. End summary.

MACROECONOMIC OVERVIEW

[2](#). (C) With GDP growth of nearly 35 percent in the first half of 2007, Azerbaijan continues to have one of the fastest growing economies in the world, driven primarily by the energy sector. Azerbaijan's energy revenues also are growing at a dizzying pace, projected to reach USD 200-250 billion over the next 15 years. The macroeconomic policy decisions that Azerbaijan makes over the next few years will be essential to our interests in this strategic country, and will lay the groundwork either for continued stability and prosperity, or the chaos and distortion that the "Oil Curse" can bring. Minister of Finance Samir Sharifov, as the GOAJ's leading economic advisor and a member of the President's inner circle, is key to Azerbaijan's economic future, and

hence to our long-term interests in the region.

¶3. (C) According to the IMF, Sharifov is pushing forward critical reforms. The IMF believes the GOAJ now fully understands the dangers of high inflation and excessive fiscal spending, and points to the relatively smaller growth rate of government expenditures in the 2008 state budget as evidence of Sharifov's moderating hand (ref a). However, the IMF continues to worry about inflation (estimated at roughly 20 percent, while official GOAJ figures are 16 percent) and signs of incipient Dutch Disease, as evidenced by migration from rural areas, real exchange rate appreciation, and a shrinking of the tradables sector. With the assistance of BP, Finance Minister Sharifov and State Oil Fund (SOFAZ) Chairman Shamar Movsumov have established a macroeconomic modeling unit at SOFAZ that they are using to educate GOAJ Cabinet officials on the dangers of excessive spending (ref b).

¶4. (C) Our senior-level policy dialogue with Sharifov and Movsumov, elevated at the inaugural bilateral Economic Partnership Commission (EPC) meeting in February, is central to our efforts to help the GOAJ manage its precarious economic transition. We hope Sharifov's meetings in Washington will encourage the GOAJ to take action on its unmet EPC commitments, particularly in the areas of legislative reform and co-financing. The GOAJ has not submitted to Parliament key legislation on Anti-Money laundering and terrorist financing, conflicts of interest, or the necessary amendments to the civil code creating criminal liability for corporations/legal persons, as promised at the EPC. We understand that these pieces of legislation still await approval from President Aliyev's office. Submission of these key pieces of legislation to Parliament for consideration in its autumn session would be an important

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demonstration of the GOAJ's commitment to rule-of-law and serious anti-corruption measures. The GOAJ also has been slow to respond to our proposed structure for the co-financing working group, although Sharifov confirms the GOAJ's commitment to co-financing and funding in the 2008 draft budget (septel).

SOVEREIGN WEALTH FUND

¶5. (C) Azerbaijan is an emerging player in sovereign wealth funds, and Finance Minister Sharifov and SOFAZ Chair Movsumov are the architects of Azerbaijan's investment policy. SOFAZ, which invests exclusively in government-issued bonds, is investing a great deal of Azerbaijan's energy revenues in U.S. Treasury Bonds. Of the Oil Fund's current USD 2 billion in holdings, we estimate that roughly half currently is held in U.S. Treasury notes. Azerbaijan's U.S. Treasury holdings will increase significantly over the next two years, as the GOAJ's take from its major oil Production Sharing Agreements skyrockets from a low of 25 percent to an eventual 80 percent by 2008-2009 and the GOAJ pursues the diversified investment strategy it outlined in detail to A/S Sullivan in August. According to press reports, the GOAJ is also considering shifting more of its fund to European investments; U.S. Treasury officials may wish to discuss this with SOFAZ Chair Movsumov and Finance Minister Sharifov.

COMMERCIAL AGENDA

¶6. (C) Azerbaijan is using a significant amount of its new energy wealth to embark on an ambitious capital investment plan, focused on key infrastructure such as power plants, roads, water, and low-cost housing. Minister of Economic Development Heydar Babayev has told us repeatedly that he welcomes U.S. companies' participation in these projects. Minister of Finance Sharifov is traveling to the U.S. with a specific commercial agenda, seeking meetings with GE and EXIM

to discuss a contract for turbines and other equipment purchases from the U.S., meetings with Dow Chemical and Honeywell to discuss UOP's work on a new refinery and a possible petrochemical project, and a meeting with Bechtel to discuss financing options for a new road from Baku to the Georgian border. In Azerbaijan's murky business environment, where official tenders often are issued after the GOAJ has identified its partner of choice or sometimes even not at all, these types of personal meetings are required to initiate and seal deals.

ENERGY

17. (C) Minister Sharifov is a player in formulating and implementing Azerbaijan's energy policy. Azerbaijan is currently poised to begin the second phase of its energy sector development, the first phase having drawn to a close with the start of oil flow through the BTC pipeline and gas flow through the South Caucasus pipeline. However, negotiations between Azerbaijan and the BP-led consortium responsible for developing Azerbaijan's major oil field have stalled, due to Azerbaijan's insistence on resolving short-term disagreements worth potentially billions of dollars before discussing possible future development of Azerbaijan's oil reserves. Concerning gas, this breakdown in negotiations has negatively affected efforts by the Consortium to seek the rights to develop the "ACG Deep Gas" field that is the largest source of gas reserves outside of the currently producing Shah Deniz Field. Stage Two development of the Shah Deniz gas field is also being held up by the lack of progress in negotiations between Azerbaijan and Turkey concerning gas transit through Turkey, with Azerbaijan claiming that Turkey's insistence on a scheme whereby Turkey can buy at sub-market prices a percentage of Azerbaijani gas transiting through Turkey is unworkable and unfair.

18. (C) In this regard, Sharifov recently expressed an interest in seeking a USTDA feasibility study on a gas transit regime through Turkey. President Aliyev told the Ambassador on October 8 that he approves the idea and hopes USTDA will support it (ref c). Gas transit through Turkey is an issue with major consequences for Azerbaijan and its ability to export its gas to European markets, which itself is a policy goal of the USG, as it serves to enhance European Energy Security. The transit regime proposed by Turkey for

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future amounts of Azerbaijani gas is predicated on a "netback" scheme that the Azerbaijani government feels is both unworkable and intrinsically undesirable, as it will force them to sell its gas at sub-market prices to Turkey. Sharifov is also deeply involved in broad reform of Azerbaijan's energy sector, including on pricing, regulation and infrastructure development.

WTO

19. (C) With help from USAID's Trade and Investment Project, Azerbaijan is making slow but significant progress towards World Trade Organization (WTO) accession. To reaffirm its political commitment, the GOAJ has set aside USD 300,000 for WTO activities in 2007 and USD 925,000 for 2008. The GOAJ is on track towards its goal of holding a Working Party meeting in Geneva in mid-December and has set October 25 as the target date for submitting new responses to questions and answers, approximately 20 pieces of WTO-compliant legislation and a revised goods offer to WTO Working Party members. After submitting its revised package to Geneva, the GOAJ intends to formally ask for a meeting around mid-December, giving members the minimum six weeks to review the submitted materials. The MFA will use the intervening six weeks to lead bilateral negotiations with the members using the new goods offer and previously submitted services offer.

However, progress is slowest in areas like agriculture (particularly wine and tobacco quotas), excise taxes (which are different for local and foreign products), and duties regulations. Sharifov's visit is a good opportunity to applaud the progress that has been made and urge more GOAJ action, particularly with duties regulations where Sharifov plays a large role.

COMMENT

¶10. (C) Finance Minister Sharifov is one of the top advisors to President Aliyev on issues of critical importance to Azerbaijan's economic success -- both developing as a market economy and managing the challenge of a massive inflow of oil revenues. SOFAZ Director Movsumov is an equally influential "junior" partner in the small circle of reformers around Aliyev, and the architect of the Oil Fund's plans to invest large amounts of Azerbaijan's oil wealth in the U.S. and in Europe. At the February EPC, we agreed to deepen our dialogue with Azerbaijan on macroeconomic issues in response to President Aliyev's request and his recognition that the GOAJ "has no experience" managing such large revenues and "can make mistakes." We urge that the Department and Treasury meet at senior levels with these key players.

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